United States Court of Appeals

for the Second Circuit

APPELLANT'S REPLY BRIEF

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76-7382

United States Court of Appeals

For the Second Circuit

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CHARLES R. WOLFSON, RICHARD R. WOLFSON and LOUIS OKIN, as Executors of the Estate of NATHANIEL C. WOLFSON, deceased, and HERBERT A. FUENTE,

Plaintiffs-Appellants,

against

STEIN ROE & FARNHAM, STEIN ROE & FARNHAM STOCK FUND, INC., STEIN ROE & FARNHAM BALANCED FUND, INC., and HENRY THIELBAR,

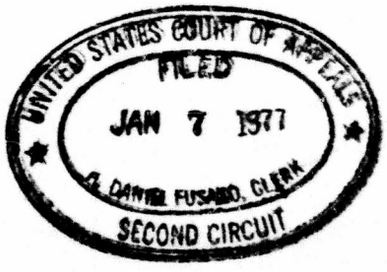
Defendants-Appellees and Cross-Appellants,

R. DOUGLASS COOPER, CHARLES FARNHAM, HARRY HAGEY, JR., LAWRENCE HICKEY, LEMUEL HUNTLEY, JOHN PEUCK, SYDNEY STEIN, JR., RICHARD TEMPLETON, JOHN LITTLE, ROBERT WOODS, SR&F SERVICE CORPORATION, WALKER-ADAMS DATA SERVICE CORP.,

Defendants.

On Appeal from the United States District Court for the Southern District of New York

PLAINTIFFS-APPELLANTS' REPLY BRIEF



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PLAINTIFFS-APPELLANTS' REPLY BRIEF

POINT I

GALFAND V. CHESTNUTT, DECIDED BY THIS COURT SUBSEQUENT TO SERVICE OF PLAINTIFFS-APPELLANTS' BRIEF, SUPPORTS A REVERSAL HEREIN.

Defendants and the Court below relied heavily on Saxe v. Brady, 184 A. 2d 602 (Ch. Del. 1962) and Acampora v. Birkland, 220 F. Supp. 527 (D. Colo. 1963). For example, in its 4th conclusion of law the Court below held:

> 4. In order to succeed on their claim in Count One that the management fees were so excessive as to violate 15 U.S.C. §80a-36, plaintiffs must demonstrate a wilful conversion by defendants and that the amount of the fees are so "shocking" that no director with sound business judgment would approve them; see Acampora v. Birkland, 220 F. Supp. 527, 548 (D. Colo. 1963); Saxe v. Brady, 184 A. 2d 602, 610 (Ch. Del. 1962) (Seitz, Chancellor).

On this appeal, defendants eschew these cases entirely. That is because this Court, in Galfand v. Chestnutt, F.2d (2d Cir., Decided November 4, 1976, Docket Nos. 76-7156, 76-7170, slip op. 409, 417), observed in footnote 12:

> Congress implicitly approved evaluation of advisory fee structures under traditional equitable standards by disavowing cases which upset management contracts only upon a showing of "corporate waste" See, e.g., Saxe v. Brady, 184 A.2d 602 (Del. Ch. 1962); 1970 U. S. Code Cong. & Adm. News, pp. 4901-03.

Throughout this case, defendants have sought to justify their advisory fee structure as not being "shocking or "unconscionable" or amounting to corporate waste -- and the Court below agreed with them -- whereas plaintiffs have challenged that fee structure as falling below traditional equitable standards.

Moreover, this Court has gone even further than plaintiffs have in their main brief. Whereas we argued that the separate, highly compartmentalized disclosures made to each Fund's board did not in law or fact amount to full disclosure, this Court held:

> Moreover, even where a fiduciary has made full disclosure, it is the duty of a federal court to subject the transactions to rigorous scrutiny for fairness. (slip op. 417)

As we showed in our main brief (Point III), not only was there failure to disclose the over-all picture to both groups of shareholders, but this was compounded by material statements in defendants' printed brochure (DX-DJ) which affirmatively misled prospective and new shareholders into a reasonable belief that the Adviser was, in fact, aggregating assets of both Funds for fee purposes. TSC Industries v. Northway, Inc. U. S. , 48L. Ed. 2d 757, 766 (1976). Significantly, defendants have not responded at all to this evidence.

This Court made it clear that nothing less than "uncompromising fidelity" to the interests of a mutual fund is expected from an adviser. Galfand v. Chestnutt, supra, slip op. 412. Since the two Funds here have been artificially maintained solely for the purpose of enriching the Adviser by an additional $100,000. per year, the defendants must be held answerable in damages.

POINT II

DEFENDANTS-RESPONDENTS DO NOT MEET THE ISSUE OF THE ADVISER'S FIDUCIARY DUTY TO REDUCE ITS CLIENTS' AGGREGATE FEE.

The main thrust of defendants-respondents' brief is that, since the two Funds are legally separate, this Court has no choice but to view them separately. Like all tautologies, this too begs the central issue, which here is simply whether, given the "mirror-image character" of the two Funds found by the Court below, was there cast upon the Adviser a fiduciary duty to reduce the aggregate fee? Instead of coming to grips with this issue, defendants devote most of their brief and all of their Points I and II to justifying the dollar amount of the fees paid by each Fund. Defendants are responding to a case that was never tried and to an appeal that was never made. Contrary to what defendants assert, it is the manner of computation, not the resultant dollar amount, which measures the fiduciary duty. As taught by this Court many times, the Adviser is not simply a business man privileged to maximize gain, but a fiduciary charged with a duty to minimize its clients' fees wherever feasible. Thus, all the industry performance comparisons and expense-profit ratios arrayed by defendants are irrelevant.

Defendants' reference at pages 15-17 of their brief to the four fund complexes which do in fact aggregate assets for fee calculation is misleading. What defendants fail to mention is that in none of those four complexes is

there a mirror-image situation such as that found herein by the Court below.

POINT III

WHEN THIS SUIT WAS COMMENCED, THERE WAS A PRIVATE RIGHT OF ACTION UNDER INVESTMENT COMPANY ACT §§36(a), 37 AND FORMER §36.

In their Point III, defendants attempt to show that, as a result of the 1970 amendments to the Investment Company Act, the only private right of action available to plaintiffs is under §36(b), which expressly grants such right as of June 14, 1972. (Defendants' brief, pp. 18, 19, 21). But in making this attempt, defendants deliberately obscure the chronology of this suit in terms of the different effective dates of the 1970 amendments. The fact is that this suit was commenced on May 23, 1972, i.e. about three weeks before the effective date of §36(b). Thus, from May 23, 1967, when the action accrued, until December 14, 1970, the effective date of §36(a), a private right of action in respect of compensation under then §36 and §37 was sanctioned by Brown v. Bullock, 294 F. 2d 415, 421 (2d Cir. 1961). And until June 14, 1972, the effective date of §36(b), a private right of action under both former §36 and §36(a) was sanctioned by Moses v. Burgin, 445 F. 2d 369, 372-373 (1st Cir. 1971). (Please see our main brief, page 23).

The Court below, on motion, permitted supplementation of the complaint in accordance with the legislation taking effect during the action's pendency (5A-7A).

POINT IV

THE CROSS-APPEAL FOR COSTS IS WITHOUT MERIT. DEFENDANTS HAVE SHOWN NO ABUSE OF DISCRETION BY THE COURT BELOW IN DIRECTING THAT EACH PARTY PAY HIS OWN COSTS.

Because this was a derivative suit for the benefit of the two Funds, the Court below was persuaded to exercise its discretion against assessing the individual plaintiffs, who did not stand to gain anything personally, with defendants' costs. The Court below was certainly entitled to exercise its discretion in this respect, and clearly it did not abuse its discretion. As stated by this Court in McDonnell v. American Leduc Petroleums, Ltd., 456 F. 2d 1170 (2d Cir. 1972), at page 1188:

> We affirm. It is well-settled that under Fed. R. Civ. P. 54(d), the awarding of costs is discretionary with the trial judge.***In this case, we are not persuaded that the trial court's denial of costs to the exonerated defendant Szabo constituted an abuse of discretion.

In view of the fact that defendants' attorneys did not file an affidavit opposing plaintiffs' attorneys' application, this Court has the right to infer that defendants were content with the judgment in this respect, as long as plaintiffs did not appeal.

Respectfully submitted,

MARKEWICH ROSENHAUS MARKEWICH & FRIEDMAN, P.C.
Attorneys for Plaintiffs-Appellants

ROBERT MARKEWICH, ESQ.
Of Counsel

Service of 2 copies of the
within Brief is hereby
admitted this 7th day of
July, 1977
Signed Sullivan & Cromwell

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